# OFFICE OF THE CITY AUDITOR

# A COMPLIANCE AUDIT OF THE CITY AND REDEVELOPMENT AGENCY INVESTMENT PROGRAMS FOR OCTOBER 1985

- O NONCOMPLIANCE WITH INVESTMENT POLICY PROVISIONS DESIGNED TO MITIGATE RISK
- O POLICY INTERPRETATIONS ARE NEEDED TO CLARIFY INTENT
- O DOCUMENTATION AND CONTROLS INADEQUATE

A REPORT TO THE SAN JOSE CITY COUNCIL

**JANUARY 1986** 

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#### **EXECUTIVE SUMMARY**

In response to an August 5, 1985 Council Finance

Committee request, the City Auditor has initiated a process for monthly reviews of investments for the City and the Redevelopment Agency. The Mayor's August 5, 1985 memorandum to the Finance Committee specified that the review should cover compliance with the City's Investment Policy, safekeeping of securities and investment documentation.

During our review of October 1985 investment transactions, we tested 33 specific Investment Policy elements for
compliance. We identified that the Administration did not
comply with 7 of the 33 policy elements tested. These observed
noncompliances were with Policy provisions regarding investment
safety and security.

According to the Finance Department, "During the nine months since adoption of the Investment Policy on April 2, 1985, considerable progress has been made towards implementation of the Policy. The major work projects which have been completed over that period of time include the development of comprehensive monthly Investment Reports, the implementation of a computerized daily cash flow program, and the development of a policy prohibiting City investment in South Africa. Other major projects which have been undertaken but which are not yet complete include the development of a master repurchase agreement with security dealers and the development of a comprehensive Request for Proposals for banking services (including safekeeping)."

While these improvements are commendable, in our opinion, the observed noncompliances are significant given that safety of invested funds is the City's number one investment priority.

In addition, the Finance Department has, through its written procedures and/or its investment decisions, made certain interpretations of the City's Investment Policy. In our opinion, these interpretations of the Policy in the areas

of repurchase agreement collateral, allowable U.S. Government Security purchases, issuer distribution, and investments purchased prior to the Policy, need to be reviewed.

Further, during our review of October investments, we identified certain weaknesses in internal controls. In addition, we determined that Finance does not always maintain adequate documentation for investment transactions. In some instances, Finance does not require the documentation, while in other instances, the documentation is required, but not consistently maintained. Such documentation is necessary to facilitate 1) third party review of investment activities 2) day-to-day investment activities, and 3) management oversight of the investment program.

Finally, we conducted a follow-up on implementation of recommendations contained in our review of September 1985 investment transactions. We found that, in most instances, Finance is implementing recommendations and that improvements have resulted. Finance is working on implementation of 1) evaluation of dealer's financial condition, 2) services agreements with dealers, 3) an investment procedures manual and 4) documentation of cash flow information.

#### It is recommended that:

#### Recommendation #1:

Finance comply with Policy requirements to execute formal safekeeping agreements with the City and Redevelopment Agency's Custodial Agents to assure that the City's interest in securities is adequately perfected. (Priority 1)

#### Recommendation #2:

Treasury staff comply with Policy requirements to maintain collateral at 100% of the repurchase agreement's face value, marked-to-market daily, or sufficiently in excess of the agreement's face value. (Priority 1)

#### Recommendation #3:

Finance comply with Policy requirements to establish procedures to evaluate and monitor dealer financial condition and execute formal master repurchase agreements and services agreements with dealers. (Priority 1)

#### Recommendation #4:

Treasury establish guidelines for repurchase agreements which 1) allow substitution of securities only on an exception basis, and 2) limit the number of securities used as collateral. Treasury document reasons for exceptions to the guidelines. (Priority 1)

#### Recommendation #5:

Finance obtain clarification from the Private Sector Investment Committee regarding the issues of repurchase agreement collateral, issuer percentages, and financial institution qualifications. (Priority 2)

#### Recommendation #6:

Finance include in its Monthly Investment Report all investments which do not comply with Policy Provisions.

Finance should indicate which investments are subject to ongoing review for potential sale. (Priority 2)

#### Recommendation #7:

Accounting ensure that safekeeping receipts are promptly received and reconciled. (Priority 1)

#### Recommendation #8:

Treasury establish data entry standards to ensure the accuracy of MONEYMAX entry, including adequate issuer identification. (Priority 1)

#### Recommendation #9:

Treasury enter the dealer's name and securities held as collateral for repurchase agreements into the MONEYMAX system.

(Priority 1)

#### Recommendation #10:

Treasury document daily investment strategy and purchase decisions. (Priority 2)

#### Recommendation #11:

Treasury segregate the functions of investing funds and receiving investment income. (Priority 1)

#### Recommendation #12:

Finance establish additional procedures to ensure that controls are functioning and written verification of purchases and sales is complete and timely. Specifically, procedures need to be established to 1) monitor compliance with Policy provisions regarding release of funds or securities 2) provide for 24 hour preparation and mailing of confirmations 3) implement pre-numbered and controlled confirmation documents and 4) date stamp and reconcile dealer, safekeeping, debit and credit advices as received. (Priority 2)

#### Note Regarding Priority Codes

The City Administrative Manual identifies a Class I Priority Code as "Fraud or serious violations are being committed; significant fiscal or equivalent losses are occurring." The stipulated implementation action is "mandatory and immediate." For the purpose of this report, a Priority I code means "non-compliance with significant City policies" and that corrective action should be mandatory and immediate.

#### **AUDIT SCOPE**

Our review of October 1985 investment transactions was designed to ascertain Administration compliance with the City's Investment Policy. In addition to areas covered in the September 1985 review, we included 1) the safekeeping of the City's securities, 2) collateral maintenance, and 3) portfolio mix restrictions for issuers. A summary of the areas reviewed and the attendant results for September 1985 investments and October 1985 investments is contained in Appendix A.

It should be noted that our review is not an all inclusive review of investment transactions or Investment Policy provisions. However, we have attempted to include the most critical Policy requirements.

#### FINDING NO. 1

# PROVISIONS DESIGNED TO MITIGATE RISK

During our review of October 1985 investment transactions we tested 33 specific Investment Policy elements for compliance. We identified that the Administration did not comply with 7 of the 33 policy elements tested. (Refer to Appendix A.) These observed noncompliances were with Policy provisions regarding investment safety and security. In our opinion, such noncompliances are significant, given that safety of invested funds is the City's number one investment priority.

According to the City's April 2, 1985 Investment Policy, the stated objectives of San Jose's Investment Program are, in order of priority:

- Safety of invested funds;
- Maintenance of sufficient liquidity to meet cash flow needs; and,
- 3) Attainment of the maximum yield possible consistent with the first two objectives.

In order to assure the safety of invested funds, the City's Investment Policy contains several provisions regarding the physical security of City investments, collateralization requirements for repurchase agreements, and dealer service agreements.

#### Noncompliance With Physical Security Policy Provisions

According to the City's Investment Policy:

"...The physical security or safekeeping of the City's investments is also an important element of safety. Detailed safekeeping requirements are defined in Section III of this Policy..."

Section III of the Policy imposes the following physical security requirements:

"The City shall contract with a bank or banks for the safekeeping of securities either owned by the City as part of its investment portfolio or held as collateral to secure time deposits or repurchase agreements." (Emphasis Added)

Our review, however, revealed that the Administration has not executed formal up-to-date contracts for the safekeeping of securities either owned by the City or being held on behalf of

the City as collateral for repurchase agreements. [1]
Accordingly, the City's legal status and remedies in the event
of bank or dealer failure is not clear.

The main banks for the City and the Redevelopment Agency, Wells Fargo and Bank of America, act as the City's "Safekeeping Agents" based primarily upon verbal understandings and the terms stipulated on the back of the safekeeping "receipts" issued by the banks. Such an arrangement is not in consonance with the City's Investment Policy or sound investment practices.

The wording on the back of the bank's safekeeping "receipts" (see Appendices B and C) clearly indicate the unilateral nature of the agreements. As such, the banks are free to amend the wording and therefore the terms of the agreement at will. Further, under the current wording, the banks are free to comingle the City's securities with other bank-held securities or to substitute other like type or value securities for the original securities the City purchased.

In response to a City Auditor request the Bank of America provided a copy of a safekeeping agreement with the Redevelopment Agency. It should be noted, however, that the contract is nearly eight years old, references another contract that was executed in 1971 and shows as authorized signatures an Executive Director, Director of Finance, and Controller, who no longer work for the City (See Appendix E). Accordingly, this is not an up-to-date contract for the safekeeping of Redevelopment Agency securities.

The absence of up-to-date contracts with Wells Fargo and Bank of America for the safekeeping of the City's securities not only leaves the City vulnerable to unanticipated bank initiated changes in safekeeping policies, but creates a vagueness as to exactly what services the banks are to provide and at what cost to the City. [1]

In a Report titled <u>Special Task Force on Audits of</u>

<u>Repurchase Securities Transactions</u>, the American Institute of

<u>Certified Public Accountants</u>, states:

"....Possession of the underlying securities may be obtained either directly by the buyer-lender (the City) or indirectly through a third party (the banks) that, acting as the buyer-lender's agent, takes possession of and holds the securities for the exclusive use of the buyer-lender. Such a custody agreement should be evidenced in writing for the buyer-lender's protection, and the custodian should be required to specifically identify and segregate the securities held for the buyer-lender...." (Emphasis Added)

<sup>[1]</sup> The cost of safekeeping services is included in overall bank service charges. However, these charges are also not documented in an up-to-date formal master contract.

The use of a safekeeping agreement is particularly important when the City is participating in repurchase agreements. A typical repurchase agreement occurs when the City transfers funds to a financial institution (dealer) and the dealer transfers securities to the City and promises to later repay the funds plus interest in exchange for the same securities. In a repurchase it is the City's main banks that actually receive the securities from the dealer, release funds to the dealer, receive funds from the dealer and finally release the securities back to the dealer to complete the repurchase. How the City's banks perform all of the above repurchase agreement activities is critical in terms of protecting the City's interest.

In its <u>Cash Management and Investment Policies and Procedures For Use By Local Government Officials</u> [1], the New York State Comptroller's Office recommends that, in order to effectively safeguard investments, local governments should require execution of a written custodial agreement between the custodial bank and the local government setting forth the local government's interest in the collateral (the securities in a repurchase agreement).

<sup>[1]</sup> The Government Finance Officers Association awarded this project its 1985 Award for Excellence in Finance Management in the Cash Management Category.

#### Noncompliance With Collateralization Policy Provisions

The City's Investment Policy imposes the following collateralization requirements:

"All repurchase agreements and all time deposits over \$100,000 shall be collateralized. The collateral for repurchase agreements shall be U.S. Treasuries or Government Agency issues, if available, whose market value at the time of purchase is equal to 100 percent of the repurchase agreement's face value. For other than overnight investments the required collateral for repurchase agreements shall be marked-to-market on a daily basis and maintained at an amount equal to 100 percent of the repurchase agreement's face value. Alternatively, the amount of collateral provided for the repurchase agreement may be set at a value sufficiently in excess of the repurchase agreement's face value to protect against a sudden decrease in the collateral's value." (Emphasis Added)

In the event that a dealer does not fulfill an agreement to repurchase, the securities serving as collateral would become part of the City's portfolio. Thus, the value of the securities must be sufficient to cover the City's purchase costs and to allow a prompt, cost recovery sale. Since the market value of securities is subject to change during each day's trading, generally accepted investment practices require that market values be monitored each day that the market is open.

Our review revealed however, that the Administration is not "marking-to-market" on a daily basis the collateral for repurchase agreements. As a result, the City is exposed to risk when the market value of the securities exchanged in a repurchase agreement is less than the funds transferred to the dealer. Further, our review revealed that such a situation did in fact occur in October 1985.

All of the authoritative literature reviewed by audit staff on the subject of repurchase agreements stressed the importance of marking to market. For example, an article in the Federal Reserve Bank of Atlanta, September 1985, Economic Review, states:

<sup>&</sup>quot;... Customers must take steps to deal with the risk that large interest rate and securities price changes can erode their protection. After establishing margin, parties to repos should set up procedures for monitoring the value of the securities and for making adjustments that continue to provide sufficient value to protect them. This process is called "marking-to-market" and should be done each day or whenever intraday price changes are large....." (Emphasis Added)

The Municipal Finance Officer's Association, in its April 1983, Suggestions for Prudent Short-Term Investments of Public Funds, states

"...Collateral should be marked-to-market or otherwise protected against price deterioration..."

The New York State Office of the Comptroller, in its <u>Cash</u>

<u>Management and Investment Policies and Procedures for Use by</u>

<u>Local Government Officials</u>, also recommends marking-to-market:

"...While repurchase agreements are useful cash management tools, they expose the investor to serious risks. It is possible by complying with complex and highly technical requirements to reduce the risk. Investment personnel must be able to negotiate complex agreements with trading partners and custodial institutions and thereafter monitor their investments on a daily basis. If a local government has a small portfolio or investment staff, these requirements may be too burdensome and other methods of cash management should be used..." (Emphasis Added)

According to Treasury staff, while they do not prepare daily calculations to document the mark-to-market process, they do in effect mark-to-market by visually monitoring general market trends. It should be noted, however, that such a practice fails to take into account the individual vagaries of particular securities. Further, the Federal Reserve Bank of Atlanta specifically cautions against such a practice in its September 1985, Economic Review:

...Interest rates can fluctuate substantially during a repo's (repurchase agreements) life.

The risk that a sustained price move erodes the value of collateral is larger the longer the maturity of the securities used and often the longer the term of the repo. This does not mean investors should rely on favorable price trends, if they develop, since day to day volatility can also be significant. For example, in one two-week period earlier this year, long-term bonds rose by 4 percent of face value. Yet, in a single day during that period, prices fell by over 2 percent of face value..." (Emphasis Added)

In our opinion, the Administration's failure to mark-to-market on a daily basis is not in compliance with the City's Investment Policy and exposes the City to unnecessary investment risk.

In a repurchase transaction, the dealer establishes the purchase cost using the dealer's estimates of market value. When audit staff reconstructed market values, we found that, in two instances, the dealer's market value computations were higher than the actual market value by nearly 1 percent or \$102,000. Thus, the securities held as collateral were not sufficient to cover the face value of the repurchase agreement.

In addition, in reviewing repurchase agreements other than overnight, staff found that the market value of some securities fell during the term of the repurchase agreement. As a result, the City was again exposed to risk to the extent of the under collateralized amount of the repurchase agreement. In the immediate instance, the City's exposure was

approximately \$9,000. While the \$102,000 and \$9,000 amounts may not be relatively significant they do demonstrate the importance of protecting the City's investment position by marking-to-market on a daily basis.

It should also be noted that Treasury staff was unable to readily provide information to reconstruct the market value of certain securities the City has accepted as collateral in repurchase agreements, such as FHLMC and GNMA Mortgage Bonds. Treasury relied upon the dealer to provide this information. Thus, the advisability of accepting such securities as collateral in a repurchase agreement is questionable (See Pages 22-25 for additional comments on this issue).

#### **Noncompliance With Policy Dealer Provisions**

#### **Dealer Prequalification and Contracts**

The Investment Policy requires that the safety of invested funds be insured via procedures designed to mitigate credit risk. The policy specifically requires (Section I.A.1.a) that the City shall prequalify the financial

institutions with which it conducts business. In addition, the Policy (Section II E and F) specifies that:

- "...Each bank, savings and loan and security dealer, otherwise qualified under the provisions of this policy, who wishes to do business with the City shall submit a copy of its latest financial statement to the City including a balance sheet and profit and loss statement. After a review of the financial statement and all other relevant information, the City will determine whether a service agreement should be executed with the institution based on the standards outlined in this Policy. The City requires that an agreement for services be executed prior to entrusting its funds to any dealer or financial institution, and that up-to-date financial statements be sent to the Director of Finance upon their issuance."
- "...The City shall annually send a copy of the current edition of this Investment Policy to all institutions which are approved to handle City of San Jose investments. Receipt of the policy shall be acknowledged in writing within thirty days."

The Policy additionally requires (Section II B) that:

"Aside from LAIF, insured deposits, and U.S. Treasury and Government Agency issues, investments shall be placed only in those instruments and institutions rated favorably by the Keefe, Bruyette and Woods Bank and Savings and Loan Rating Service or Moody's Commerical Paper Record. For Banker's Acceptances and Negotiable Certificates of Deposit, depositories shall be limited to banks and savings and loans rated "B" or better, and selected major California banks rated "C" or better. Except for insured deposits in California banks and savings and loans, City investment transactions will be conducted only with institutions meeting the tests described above, and/or with dealers from the list of Government Security dealers reporting to the Market Reports Division of the Federal Reserve Bank of New York. Except for investment in Banker's Acceptances and Negotiable Certificates of Deposit, the City will limit its investments in banks and savings and loans to those institutions maintaining offices in the San Jose Area."

Of the 10 dealers [1] involved in October transactions, our compliance review revealed the following:

Complia	nce	Compliance With	
Questions		Policy	
		# YES	# NO
1. R	eports to Market Report	8	2
D	ivision of Federal Reserve?		
2. A	cknowledged City Investment	10	
P	olicy?		
3. F	inancial Statements:		
a	) Filed?	5	5
b	) If filed:		
	o Include Balance	5	
	Sheet?		
	o Include Profit and	3	2
	and Loss Statement?		
	o Are current?	5	
	o Reviewed by Finance?		5
4. Ha	s Service Agreement with Cit	y?	10

<sup>[1]</sup> Includes banks or savings and loans acting as dealers.

Published guidelines emphasize the importance of evaluating the financial condition of dealers and executing formal master agreements with dealers. The dealer master agreement should specify service expectations and the terms of repurchase transactions. Alternatively, separate documents can be executed for the Services Agreement and the Master Repurchase Agreement.

Regarding the importance of evaluating the financial condition of dealers, a June 1985 public information flyer from the Federal Reserve Bank of New York cautions:

Develop standards for choosing your trading partners and review their performance regularly.

Know the people you are dealing with and gather credit information about their firm. This should include information about the background of the firm and the capabilities of its management. Check references and seek advice from experienced professionals. Sometimes dealer firms have a number of affiliates, some with greater financial strength than others. Be sure of exactly who your counterparty is.

Request reports about the financial condition of the firm on a regular basis and certification of conformity with accepted capital standards. Make sure you have annual audited statements of the firm which is your counterparty.

Consider the level of capital in the firm. Also look at the ratio of assets to capital, and total outstanding repurchase agreements in relation to capital. For example, a high ratio of assets to capital should prompt more questions."

In addition, the Government Finance Officers
Association (GFOA) [1] recommends that:

"...Before an unfamiliar security is purchased, the investment program should include basic research on the issuer and the instrument. Whenever possible, financial statements should be obtained to verify capitalization and profitability. If ratings have been assigned by a recognized rating agency, they should meet local criteria."

Further, The New York State Comptroller's recommended Investment Policy for Local Governments<sup>[2]</sup> states:

"All trading partners must be credit worthy. Their financial statements must be reviewed at least annually by the Chief Fiscal Officer to determine satisfactory financial strength or the Chief Fiscal Officer may use credit rating agencies to determine credit worthiness of trading partners."

Authorities are equally emphatic about the importance of formal contracts between customer and dealer, particularly to substantiate the terms of repurchase agreements.

- [1] Special Bulletin, April 1983, Municipal Finance Officers Association, "Suggestions for Prudent Short-Term Investment of Public Funds"
- [2] Cash Management and Investment Policies and Procedures for Use by Local Government Officials, State of New York, Office of the State Comptroller, December 1984.

According to an Associate Counsel at the New York Federal Reserve, such agreements, or master contracts should include the following:

"Each transaction under the master contract should be confirmed separately in writing. The terms used and the duration of the agreement must be defined and confirmation procedures and wording should be carefully set out. The means of delivery and manner of payment need to be described. The dealer should warrant that his actions are authorized and that he will provide customers with periodic financial statements promptly. Also, unregulated dealers should agree to provide the certifications specified under the Fed's voluntary capital adequacy guideline.

To minimize risk associated with changes in the market value of securities, repurchase contracts—especially "term repos" lasting longer than overnight—should include provisions for margin adjustments. These assure that the value of the securities the customer has received is adjusted to reflect changes in their market price. The contract should specify whether this adjustment is to be accomplished by the transfer of additional securities from the dealer to the customer or by the return of funds to the customer. Any failure by the dealer to perform any act called for by the contract should be defined as an act of default, allowing the customer to close out his position." [1]

In addition, New York State Guidelines, previously referenced, state:

"Written contracts shall be required for all Repurchase Agreements. Only credit worthy banks and primary reporting dealers shall be qualified to enter into a Repurchase Agreement with the Local Government. The written contract shall

[1] Ringsmuth, Don, "Custodial Arrangements and Other Contractual Considerations," <u>Economic Review</u>, Federal Reserve Bank of Atlanta, September 1985.

provide that only obligations of the United States may be purchased, and the Local Government shall make payment upon delivery of the securities or appropriate book-entry of the purchased securities. No specific repurchase agreement shall be entered into unless a master repurchase agreement has been executed between the Local Government and the Trading Partners. While the term of the master repurchase agreement may be for a reasonable length of time, a specific repurchase agreement shall not exceed thirty (30) days."

Further, the American Institute of Certified

Public Accountants (AICPA), Special Task Force on

Audits of Repurchase Securities Transactions, recently

(June 1985) issued a report which states:

"To create a valid security interest under the Uniform Commercial Code, the safest approach is to have a separate signed agreement specifically creating the security interest and to perfect the security interest, normally by possession of the collateral."

"...If a buyer-lender under an RP-RRP (repurchase) agreement with a securities dealer does not perfect a security interest in securities purchased, for example, by having a signed agreement and by taking possession, either directly or through a custodian acting as its agent, the potential economic loss also extends to the full value of the securities and the risk assumed becomes that of an unsecured lender, namely, credit risk." (Emphasis Added)

Thus, it is clear that formally executed Master

Repurchase Agreements are essential to protect the investor's interests.

Finally, authoritative literature and prudent practice indicates that Treasury should establish guidelines for repurchase agreements which 1) limit the number of securities used as collateral, and 2) allow for the substitution of securities only on an exception basis. These terms should also be incorporated into the Master Repurchase Agreements with dealers. If exceptions to these requirements are necessitated due to dealer inventory at the time of settlement, the reasons should be documented.

During our review of October investments, we noted that a number of repurchase agreements were collateralized by multiple securities. In some instances, there were as many as ten to eighteen different securities collateralizing the repurchase agreement. The use of multiple securities as collateral impedes accurate monitoring of market value. (See Pages 7-11 on marking-to-market).

During our review we also noted two instances where the dealer exchanged securities for those originally specified in the repurchase agreement. In one instance, audit staff was not able to document if Finance 1) verified the value of these securities or the date of delivery or 2) authorized the substitution. Such a practice is not a prudent one since it may jeopardize the sufficiency of the collateral in the repurchase agreement thereby creating risk for the City.

Security substitution and multiple-security collateral also impose additional workload for Accounting personnel who must reconcile dealer confirmations, safekeeping receipts and bank debit and credit advices for <u>each</u> security held as collateral.

#### CONCLUSION

Safety of invested funds is the City's number one investment priority. Our review, however, revealed that the Administration is not complying with certain Investment Policy provisions designed to ensure investment safety. Finance should comply with Policy provisions to ensure the safety of invested funds. Specifically, Finance should 1) execute formal safekeeping agreements, 2) monitor repurchase collateral by marking-to-market daily, 3) evaluate and monitor dealer financial condition, and 4) execute master services and repurchase agreements with dealers.

#### Recommendation #4:

Treasury establish guidelines for repurchase agreements which 1) allow for the substitution of securities only on an exception basis, and 2) limit the number of securities used as collateral. Treasury document reasons for exceptions to the guidelines. (Priority 1)

### FINDING NO. 2

# POLICY INTERPRETATIONS ARE NEEDED TO CLARIFY INTENT

The City's Investment Policy is primarily a management tool to be used to meet the stated objectives, in order of priority, of safety, liquidity and yield. As a policy declaration, it does not, nor cannot, address every decision required in an investment program. Management is therefore given the latitude to interpret the policy in certain areas. The Finance Department has, through its written procedures and/or its investment decisions, made certain interpretations of the Policy. In our opinion, these interpretations regarding repurchase agreement collateral, allowable U.S. Government Security purchases, issuer distribution, and investments purchased prior to the Policy, need to be reviewed.

## Repurchase Agreements Collateral and Issuer Percentages

The Finance Department, Treasury Division routinely enters into repurchase agreements as a part of its investment

program. While the Investment Policy specifically places certain restrictions on these agreements, it is ambiguous as to the application of other restrictions contained therein.

In their Weekly Letter dated September 13, 1985, the Federal Reserve Bank of San Francisco describes a repurchase agreement as follows:

"Although a repurchase agreement may be complex in its details, its basic features are quite simple. In a repurchase agreement, an investor (or dealer) purchases securities from a dealer (or other financial institution) who agrees to buy them back at a future date at a higher price, thereby implicitly paying interest to the investor. In essence, a repurchase agreement or "repo" is a mechanism for investing funds. (Most parties in the market describe a transaction from the dealer's point of view. Thus, the above transaction, which both investors and dealers call a "repo", is lending by the investors and borrowing by the dealers.)

The role of securities in repos is to provide the lender with a means of securing collateral for the funds he has lent. (Legally, there are important distinctions between true collateralized loans and sequences of purchases and sales.)... Should the borrower in a repurchase agreement default on the agreement, ostensibly the lender would be able to sell the securities to cover the default."

#### Repurchase Agreement Collateral

The City Investment Policy states the following regarding repurchase agreement collateral:

"...The collateral for repurchase agreements shall be U.S.

Treasuries or Government Agency issues, if available, whose market value at the time of purchase is equal to 100 percent of the repurchase agreement's face value."

Currently, the Finance department does not evaluate the securities taken as collateral in a repurchase agreement against restrictions of the policy other than the one mentioned above. Specifically, the Policy restricts purchases of U.S. Government Agency issues to:

- Issues of the Federal Farm Credit Bank, the Federal Home Loan Bank and the Federal National Mortgage Association.
- 2. Issues with maturities not to exceed 3 years.

One interpretation of the City's Investment Policy is that the securities taken as collateral for a repurchase agreement should meet all policy restrictions to enhance the safety of invested funds as intended by the Policy.

For example, the Government Finance Officers Association,
A Guide for Local Government, June 1982, states:

"A few words of caution on repurchase agreements are necessary. First, it is important that the local government treasurer specify what type of instrument will be used in the agreement. ... A local government may not use an instrument in a repo in which it is unable to directly invest, since the agreement represents a temporary purchase of the instrument." (Emphasis added)

While the above quotation concerns the type of securities in which a local government can <u>legally</u> invest, the intent seems clear that a repurchase agreement represents a temporary purchase and therefore all legal <u>and</u> self-imposed (policy) restrictions should apply.

Our review of the October transactions disclosed 16 repurchase agreements in which the collateralized securities were inconsistent with one or more policy provisions regarding purchases. In the City portfolio there were 7 transactions in which the types of securities met policy restrictions but the maturity dates were beyond the three year limitation. The maturities range from 4 years to 30 years.

In the Redevelopment portfolio, there were 5 agreements collateralized with securities which met neither the type of security nor maturity limitations and two agreements which were collateralized by securities which exceeded the three year maturity limitation.

#### **Issuer Limitation**

The Finance Department does not consider monies invested in repurchase agreements in calculating the percentage of the portfolio invested in a single institution. The rationale being that the agreements represent a purchase of U.S. Treasury or Government Agency issues and, therefore, are not considered as being invested with the institution. This interpretation, coupled with the interpretation evidenced in the preceding section regarding repurchase collateral, reflects the administration's position that repurchase agreements are not subject to the Policy's type of instrument or diversification restrictions.

Accordingly, it appears that a Policy section needs to be developed regarding the status of repurchase agreements relative to other Policy restrictions.

In discussing the safety of invested funds, the Policy states that:

#### "Safety of Invested Funds

The City shall insure the safety of its invested idle funds by limiting credit and interest rate risks. Credit risk is the risk of loss due to the failure of the security issuer or backer.

#### a. Credit risk will be mitigated by:

"...diversifying the investment portfolio so that the failure of any one issuer or backer will not place an undue financial burden on the City ..."

The policy continues as follows:

"No more than 10% of the total portfolio shall be invested in the issuances of any single institution other than securities issued by the U.S. Government and its affiliated agencies."

In interpreting these provisions of the Policy, the Finance Department has concluded that the calculation of 10% limitation should not include repurchase agreements.

In our opinion, such an interpretation should be reviewed, particularly if the intent of the Investment Policy is to mitigate credit risk through the diversification of the City's investments. This is accomplished by restricting the amount of money placed in the securities of any single institution at any point in time. During our October review, we noted that in the Redevelopment portfolio, the 10% limitation was exceeded throughout the month when the amount of

repurchase agreements with a single institution were compared to the total portfolio as shown below.

<u>Dealer</u>	Date	Percentage of Total Portfolio	
Kleinwort Benson	10/1/85	33.2 %	
	10/2/85	28.2 %	
	10/10/85	19.5 %	
	10/22-24/85	_	
	10/25-29/85	Гял	
Morgan Guarantee	10/1/85	28.2 %	
Bank of America	10/30-31/85	19.8 %	
Bankers Trust	10/15-21/85	19.1 %	
Dean Witter	10/1/85	13.9 %	

We believe this position exposes the investment program to additional risk should the dealer have financial difficulties and not fulfill its obligations under the repurchase agreement. Accordingly, application of the diversification provisions of the Investment Policy to repurchase agreements seems prudent and appropriate.

<sup>[1]</sup> Percentage change due to fluctuation in portfolio total.

# **Purchases Prior To Policy**

In the October Monthly Investment Report for the City portfolio, Finance states that:

"...Staff will also continue to monitor opportunities to sell those instruments which do not comply with the City of San Jose's Investment Policy. ...Schedule D is a listing of any securities which violate any portion of the City's current Investment Policy as of October 31, 1985."

It should be noted that Schedule D is not a complete compilation of all prior purchases which violate the current policy. There are 64 exceptions to Policy requirements for authorized instruments, issuer rating and/or issuer location which are not listed. Finance should include in it's Monthly Investment Report all investments which do not comply with Policy requirements.

#### CONCLUSION

The Finance Department has made various interpretations of the City's Investment Policy regarding repurchase agreement collateral, allowable U.S. Government Security purchases, issuer distribution, and investments purchased prior to the April 2, 1985 Policy. These interpretations have raised issues which should be clarified by the City Council and/or the Private Sector Investment Panel.

# RECOMMENDATIONS

It is recommended that:

# Recommendation #5:

Finance obtain clarification from the Private Sector Investment Committee regarding the issues of repurchase agreement collateral, issuer percentages, and financial institution qualifications. (Priority 2)

# Recommendation #6:

Finance include in the Monthly Investment Report all investments which do not comply with Policy provisions.

Finance should indicate which investments are subject to ongoing review for potential sale. (Priority 2)

# FINDING NO. 3

# **DOCUMENTATION AND CONTROLS INADEQUATE**

During our review of October investments, we identified certain weaknesses in internal controls. In addition, we determined that Finance does not always maintain adequate documentation for investment transactions. In some instances, Finance does not require the documentation while in other instances, the documentation is required, but not consistently maintained. Such documentation is necessary to facilitate

1) third party review of investment activities 2) day-to-day investment activities, and (3) management oversight of the investment program.

# Safekeeping Receipts Not Reconciled

Pursuant to the custodial arrangements discussed on Page 4, the custodial banks transmit "receipts" for each security purchased or held as collateral for investment transactions. At the end of each month, the banks transmit

month-end custodial reports. These documents are transmitted directly to the Accounting Division for reconciliation to Accounting's copy of Treasury's Confirmation. This is an important control procedure to insure safeguarding of investment assets. Arthur Young and Company, in their Special Report on Investments issued September 17, 1984, specifically recommended reconciliation of safekeeping receipts.

Our review indicated that the Accounting Division is not reconciling the safekeeping "receipts". Instead "receipts" are placed in the investment folder, but are not matched to the confirmation. Accounting staff do not date stamp safekeeping receipts, so it is not possible to verify when they are received.

It should be noted that Accounting does reconcile monthly reports from the "safekeeping agents" to the Monthly Investment Report. However, this monthly report: 1) is not received until approximately the middle of the month following the month of purchase; 2) shows only securities held as of the end of the month; 3) does not always reflect all securities which should be in the account; and 4) does not contain specific Federal security identification. As a result, such a reconciliation is untimely at best and incomplete by definition.

It should be noted that Finance is working with the City and Redevelopment Agency's banks to improve the Monthly Investment Reports. However, such improvements will not absolve Accounting of the responsibility to reconcile safekeeping receipts on an "as received" basis. Such reconciliation will still be necessary to provide verification of security custody, particularly for repurchase collateral.

# **Use of MONEYMAX**

Treasury does not enter into MONEYMAX certain information which is necessary for efficient portfolio management.

Treasury does not enter the securities held as collateral for repurchase agreements, or the name of the dealer issuing repurchase agreements. In addition, Treasury does not regularly enter, the name of the issuer for bankers acceptances, commercial paper and negotiable certificates of deposit. In addition, since no standards are established for data entry, issuer identification is not consistent. As a result, investment records are not complete, information is not readily available for portfolio management, and the MONEYMAX System is not fully utilized.

During the review of September 1985 investment transactions, audit staff reviewed compliance with Policy limits for categories of investments as stated in Section II.A. These restrictions limit the total of certain categories to a percentage of the portfolio as follows:

- o Uninsured Time Deposits Not to exceed

  30% of total

  portfolio
- o Bankers Acceptances; Not to exceed

  Commercial Paper; and 30% of total

  Negotiable Certificates portfolio

  of Deposit

During the review of October transactions, we also reviewed compliance with Policy restrictions for issuers (Section II A.4). This section provides that, other than government securities, a single issuer cannot hold more than the following percentage of the total portfolio:

- o 5% for "uninsured-uncollateralized" issues
  (bankers acceptances, commercial paper, and
  negotiable certificates of deposit).
- o 10% for all other non-government instruments.

No exceptions were noted for October transactions.

However, an unreported exception to the 5% issuer limit in the uninsured-uncollateralized category was noted in the City portfolio for September 1985. It appears that this exception went undetected because Treasury staff input issuer information into MONEYMAX inconsistently. For example, Treasury staff often do not enter the name of the issuer into MONEYMAX and, when they do, no standards are applied to insure consistency of entry.

In the immediate case, the exception occurred due to three purchases from Sears Savings Bank. Following is an excerpt of an issuer listing generated by MONEYMAX.

Purchase <u>Date</u>	Instrument	Issuer	Amount	Issuer <u>Total</u>
8-1-85	NCD	Sears Savings Bank	\$5M	\$ 5M
8-22-85	NCD	Sears Savings Bank	\$4M	\$ 9M
9-17-85	Commercial Paper Discounted	Sears	\$6M+	\$20M+

As the above listing indicates, the issuer description entered into MONEYMAX was "Sears Savings Bank" for the two August purchases and "Sears" for the September purchase.

As a result, Treasury did not group the three purchases together and consequently did not recognize and subsequently report the exception, even though the purchase on September 17 caused the issuer total to exceed 5% of the portfolio total. The Policy exception lasted from September 17, until the commercial paper matured on October 1, 1985. The City Auditor notified Finance of the exception so the Director could report the exception in a timely manner. (See Appendix D)

In addition to being inconsistent in entering data into MONEYMAX, Treasury does not enter the securities held as collateral for repurchase agreements. As a result, MONEYMAX cannot monitor the market value of securities held as collateral. Treasury concurs with Audit staff regarding the need to enter and monitor repurchase collateral in MONEYMAX. Accordingly securities held as repurchase collateral will be recorded and an automated system for marking to market is being implemented by Wismer and Associates. Treasury staff began MONEYMAX training on this new MONEYMAX capability on December 20, 1985. Treasury can obtain an automated issuer percentage analyses through MONEYMAX by establishing codes for issuers and using those codes on a consistent basis.

# **Investment Decisions Not Documented**

The Government Finance Officers Association (GFOA)<sup>[1]</sup> recommends the following regarding the documentation of purchase decisions:

"A designated staff member should regularly contact brokers, dealers and/or issuers and obtain rates and prices for various maturities according to the cash management plan. Each quotation should be documented to record the date and time of the quote, the parties in the discussion, the instrument(s), maturities and rates. A grid sheet may simplify this process.

Once rates are obtained, the investment can be selected. Investment professionals should routinely note their reasons for electing a specific investment and document the logic and the risk/return problem facing them at the time of action.

Such records can prove helpful if economic conditions change and a seemingly logical investment decision proves incorrect. The diligence of the recordkeeper alone could under cut challenges."

During our review, we noted multiple purchases occurring on the same date in the City and Redevelopment portfolios without adequate documentation justifying the purchases.

[1] GFOA Special Bulletin, "Suggestions for Prudent Short-Term Investment of Public Funds," April 1983.

In response to audit staff questions, Treasury staff responded that multiple same-day purchases might occur due to:

- o Changes in market conditions that "trigger a buying opportunity;"
- o "Availability" (what is available for purchase at the time they are looking);
- o "Spreading maturity dates" to meet cash needs; and
- o Discovery of additional cash (unanticipated cash flow changes) throughout the day.

The Treasurer has initiated procedures requiring that
Treasury staff complete Call Sheets which identify dealers
contacted and rates obtained in making purchase decisions.
The use of Call Sheets is a good procedure and will provide the
only documentation of "shopping" activities. However, while
Treasury staff is instructed to obtain at least three
comparable quotes from different dealers, the sheets do not
always reflect this information.

Treasury has agreed to improve documentation by adding a brief narrative describing market conditions and investment strategy at the time of purchase.

# **Controls Not Functioning**

Under the current Treasury organization, the Banking and Investment Unit includes the Cashiering Unit. Thus, the same unit which initiates and records investment transactions also receives and deposits investment income. This does not provide for proper segregation of duties. Separation of the cashiering function from the investment function is a basic internal control standard.

In addition, the Policy requires that: 1) an employee other than the employee initiating investments telephone instructions for release of funds or securities; 2) notification to the bank must be sent within 24 hours; and 3) release of funds or securities must be in accordance with a preformatted wire transfer. A number of control procedures to insure compliance with the above requirements are not always functioning.

The Policy provides that:

"The authorization to release City securities will be telephoned to the appropriate bank by a Treasury staff member other than the person who initiated the transaction. A written confirmation outlining details for the transaction and confirming the telephoned instructions will be sent to the bank within 24 hours."

Our review revealed that in some instances the Treasury employee who instructed the bank to release funds or securities did not initial the Transaction Control Log. As a result, documentation did not always exist to verify compliance with the Policy. In addition, on average Treasury confirmations are distributed to dealers and banks approximately eight working days after the settlement date. This happens because Treasury does not normally type confirmations until two working days after settlement, and the signature process (Chief of Treasury, Finance Director, Chief of Accounting) takes an average of seven working days from the date of settlement to complete.

The Policy also provides that:

"Wherever possible, the City will use preformatted wire transfers to restrict the transfer of funds to pre-authorized accounts only. When transferring funds to an account not previously approved, the bank is required to call back a second employee for confirmation that the transfer is authorized."

Audit staff noted that there are no records to verify that the banks called back a second employee for confirmation when preformatted wire transfers were not on file for specific transactions.

Finally, audit staff identified that Treasury confirmation documents are not prenumbered and controlled to guard against unauthorized use. While this does not consititute a Policy noncompliance it does represent an internal control situation that Peat, Marwick and Mitchell & Co (the City contracted financial auditors) recommended be corrected.

It should be noted that Treasury plans to reissue preformatted wire transfer instructions and to design and order prenumbered confirmation forms.

# CONCLUSION

Improvements are needed to enhance internal controls and documentation for the City and Redevelopment Agency investment activities. Such improvements will facilitate third party review of the investment program, day-to-day investment activities, and management oversight.

# **RECOMMENDATIONS**

It is recommended that:

# Recommendation #7:

Accounting ensure that safekeeping receipts are promptly received and reconciled. (Priority 1)

# Recommendation #8:

Treasury establish data entry standards to ensure the accuracy of MONEYMAX entry, including adequate issuer identification for all investments. (Priority 1)

# Recommendation #9:

Treasury enter the dealer's name and securities held as collateral for repurchase agreements into the MONEYMAX system. (Priority 1)

# Recommendation #10:

Treasury document daily investment strategy and purchase decisions. (Priority 2)

#### Recommendation #11:

Treasury segregate the functions of investing funds and receiving investment income. (Priority 1)

# Recommendation #12:

Finance establish additional procedures to insure that controls are functioning and written verification of purchases and sales is complete and timely.

Specifically, procedures need to be established to

1) monitor compliance with Policy provisions regarding release of funds or securities 2) provide for 24 hour preparation and mailing of confirmations 3) implement prenumbered and controlled confirmation documents and 4) date stamp and reconcile dealer, safekeeping, debit and credit advices as received. (Priority 2)

# FOLLOW-UP ON PRIOR FINDINGS

Following is an implementation status report for findings contained in the review of September 1985 investment transactions. We found that, in most instances, Finance is implementing recommendations and that improvements have resulted. Finance is working on implementation of:

1) evaluation of dealer's financial condition; 2) services agreements with dealers; 3) an investment procedures manual; and 4) documentation of cash flow information.

#### Recommendation #1:

Treasury staff utilize MONEYMAX in managing the portfolio and making investment decisions by: running a portfolio profile daily or on each day when purchases, sales or maturities occur; and using the portfolio profile report in making investment decisions. (Priority 1)

#### Status:

Commencing November 5, 1985, a MONEYMAX generated

portfolio profile is produced on a daily basis. The specific report is GSIOT (Investments Outstanding by Type) which is bound in a gray cover and maintained in the Treasurer's Office. Manual calculations are noted on the report to assist in maintaining the portfolio within policy guidelines for category and issuer limits.

#### Recommendation #2:

Treasury staff insure that entry into MONEYMAX is timely and accurate by: entering transaction data on the date that the transaction occurs; running machine numbered, logged and dated batch reports for all entries; and reviewing batch reports for accuracy. (Priority 1)

#### Status:

In October, the average number of working days from settlement to data entry improved from 7 to 4.5 days. Through interviews with Treasury staff and review of transactions for November 1 to November 15, we verified that rough drafts of confirmations are prepared and the data is input into MONEYMAX

on the same day the transaction is authorized. Only one exception occurred when three November 4 transactions were entered into MONEYMAX on November 5. A logged and dated input verification report, a general journal report, an exception report, and the GSIOT report are run on the same working day the master file is updated. The reports are contained in binders in the Treasurer's Office and are available for review by outside parties. The MONEYMAX line number is assigned to the rough draft of the confirmation. The typed confirmation, including the line number, is submitted to the Chief of Treasury within 24 hours, based on a sample review of transactions.

# Recommendation #3:

Finance enhance staff's ability to utilize MONEYMAX by: providing comprehensive training for employees in the use of MONEYMAX; and preparing a simplified instruction manual on the use of MONEYMAX for Finance employees. (Priority 2)

#### Status:

Finance plans future training sessions, including training to prepare staff for planned upgrades and additional software products.

The MONEYMAX instruction manual, targeted for completion by January 1, 1986, is still in progress.

# Recommendation #4:

Treasury staff advise Finance management of portfolio status on a timely basis by distributing a copy of the portfolio profile report in Recommendation #1 to the Treasurer, Chief of Accounting and the Finance Director. (Priority 1)

# Status:

We verified that the Chief of Treasury receives a daily report of the portfolio profile to review portfolio status.

Also, the Chief of Accounting and the Director of Finance receive a daily exception report and a weekly Earned Interest Summary report for their review.

# Recommendation #5:

Treasury staff prepare revenue vouchers for maturities, sales and interest payments on the date funds are deposited or payment is received. (Priority 1)

# Status:

In October, preparation time was reduced from an average of nine to an average of five working days. We traced eight repurchase transactions for November and found that the Revenue Vouchers were written within one day of maturity for six of the transactions and within two days after maturity for the other two transactions.

# Recommendation #6:

Treasury staff maintain documentation to verify information used each day in making investment decisions, including the portfolio profile report and all cash flow information. (Priority 2)

# Status:

In the review of September investment transactions, we recommended that Treasury improve documentation for cash flow. Under current procedures, Treasury staff use a desk calendar to record investment information including various cash flow information. This information is supplemented by notes or "scratch pad items" which are discarded after use. This manual information is used to supplement the cash flow forecast produced by MONEYMAX. If received sufficiently in advance, the information is entered into MONEYMAX and included in a detailed forecast which shows revenue and expenditures for a workweek by workday.

When preparing the Daily Cash Flow, which determines funds available for investment, Treasury staff use a combination of manual notations and a printout of the MONEYMAX Forecast. No log is maintained to indicate the date, source, and content of interim cash flow information. A copy of the MONEYMAX detailed forecast is not retained "as used" each day. Thus, it is not possible to specifically ascertain what cash flow information is available to and utilized by Treasury staff in making daily investment decisions.

During the October review, audit staff discussed with Treasury potential methods of documentation. Treasury is exploring procedural alternatives.

Further follow-up will be required as the procedures are developed and implemented.

# Recommendation #7:

Finance complete procedures regarding prequalification of financial institutions. (Priority 1)

#### Status:

Treasury sent letters to dealers and banks requesting the submission of their most recent financial statements, acknowledgement of the November 1985 Investment Policy Revisions, and a written statement of policy regarding their South African involvement. Criteria for the review of the financial statements is being developed. Treasury staff has targeted January 1, 1986 as the deadline for a finalized service agreement format.

This finding is now incorporated into Finding #4 of the October Report.

Further follow-up will be required as additional information becomes available.

# Recommendation #8:

Treasury document reasons for sales.

# Status:

Treasury staff stated that procedures are in place to document the reasons for sales. Since no sales took place in November, we were unable to verify or review these procedures.

Further follow-up will be required as sales transactions occur.

# Recommendation #9:

Accounting complete improvements in reconciliation procedures.

#### Status:

This recommendation was directed at Accounting's "as-received" reconciliation of investment documents.

Reconciliation of safekeeping receipts and reports is addressed on Pages 31-33 of this report. Month-end and year-end reconciliations will be addressed in the investment program audit.

During the review of October transactions, audit staff noted that no reconciliations had occurred for the Redevelopment portfolio. For the City portfolio, Accounting had attached dealer advices and bank account debit and credit advices to the pink confirmation but had not reconciled most bank fedwire service debits and credits. Accounting does not date stamp dealer advices and does not consistently date stamp debit and credit advices. Based on a review of debit and credit advices that were stamped when received, approximately eleven days elapse from occurrence of the debit or credit to receipt of the advice. Accounting states that dealer advices are usually received in two to three days. This cannot be verified.

For November, we verified the following improvements in Accounting's reconciliation procedures:

- o Treasury enters the MONEYMAX line number on the pink copy of the Confirmation document delivered to Accounting.
- o Treasury transmits MONEYMAX month-end investment reports to Accounting at the close of the month rather than waiting for the published monthly Investment Report.

#### CITY OF SAN JOSE - MEMORANDUM

TO: Honorable Mayor and City Council

FROM: Edward G. Schilling

Director of Finance

SUBJECT:

RESPONSE TO AUDITOR'S

OCTOBER 1985 COMPLIANCE REVIEW

DATE: January 17, 1986

APPROVED

DATE

1-17-86

#### BACKGROUND

Over the past four months staff from the Finance Department and the City Auditor's Office have committed hundreds of hours to the two Investment Program Compliance Reviews. This project, which has required considerable extra effort and significant overtime on the part of both staffs, has resulted in the identification of methods and procedures to improve operation of the Investment Program, and has underlined the importance of implementing all of the provisions of the City's Investment Policy.

The City Administration and Finance Department are dedicated to making San Jose's Investment Program the best municipal program in the nation. To that end we have accorded the Investment Program much more than its proportionate share of attention over the past year. As a result of that effort the Program has made a number of significant advances which are reviewed briefly in the Auditor's Compliance Review. The areas of Policy "non-compliance" which remain to be corrected consist primarily of two types: 1) those legal agreements which will formalize relationships between the City and other key actors in the investment arena; and, 2) those procedural and operational refinements which are needed to provide accurate information for management of the investment portfolios and for Council oversight.

In approaching the implementation of various Policy elements staff has been faced with the necessity of making trade-offs between the need to put the improvements in place as quickly as possible and the importance of insuring that program elements are of top quality. Because of the long-term effect of whatever improvements are implemented, staff has opted to exercise particular care in developing program documents such as the Security Dealer Agreements and the Banking Service Request for Proposals. The exercise of sufficient care in preparing these investment program documents will insure that the Program is built and operated on a firm foundation.

We appreciate the effort which the City Auditor's Office has put into the Investment Compliance Reviews because the result will be an Investment Program of the quality which the Investment Policy anticipates. We are in general agreement with all of the October Compliance Review's Recommendations, and are expressing significant disagreement only in the area of Policy interpretations which are suggested for referral to the Private Sector Investment Panel. We concur that that forum would be well-suited to resolving our differences with regard to Policy interpretation.

The audit process can be a difficult one because both the auditor and auditee have pride in their work and a deep concern for exercising their responsibilities professionally. That fact requires a willingness on the part of both audit participants to accommodate the other's concerns to the degree that this can be done without compromising professional standards. The City Auditor's Office and the Finance Department have both demonstrated a willingness to accommodate during this Review.

The remainder of this Response deals with each Recommendation as it has been presented in the text of the Compliance Review.

#### RECOMMENDATION #1

Finance comply with Policy Requirements to execute formal safekeeping agreements with the City and Redevelopment Agency's Custodial Agents to assure that the City's interest in securities is adequately perfected. (Priority 1)

#### RESPONSE

A Safekeeping Agreement was drafted by the Chief of Treasury and was forwarded to the City Attorney for review during the week of January 13, 1986. After legal review and approval, this agreement will be presented for signature to the financial institutions providing safekeeping facilities for the City of San Jose now and in the future.

It should be noted that previous inquiries about safekeeping agreements with the current service providers had not produced satisfactory responses. One institution has had its legal department working on an agreement for 1 1/2 years and is still without a finished product. The other did provide an agreement. However, it: (1) extended no special guarantees to the City that its security interest would be perfected, (2) made no reference to governing laws or regulations, (3) established no term of agreement, (4) failed to address timeliness in crediting receipts of income, (5) included no guarantees of insurance coverage, (6) omitted conditions which would result in grounds for termination, and (7) did not describe the mechanics of termination. The Chief of Treasury decided not to sign a document which was incomplete and provided little assurance that the City's legal position was airtight in the face of: (1) complex correspondent banking relationships, and, (2) the prospect of future City liability stemming from signing an inadequately structured document. It would be a significant oversight to enter into agreements like this without a comprehensive legal review as discussed in the article prepared by the associate general counsel at Federal Reserve Bank of New York (Economic Review, Federal Reserve, Bank of Atlanta, September, 1985). Treasury has expected to proceed carefully with this project. The targeted completion date for signed agreements is April 1, 1986.

Page 3 January 17, 1986

The absence of a formal master contract for banking services referenced in the Auditor's first footnote is also a result of the process of analysis and care involved in the drafting of a Request for Proposal for Banking Services. That draft has been circulating for City staff comments since mid-December and will be released for industry comments in late January. An informational memo will be distributed to City Council within the next few weeks. Particularly since the adoption of the policy on April 2, 1985, Finance has made the development of these agreements a top priority. Work on these major projects could not commence until the Chief of Treasury began working on May 30, 1985.

# RECOMMENDATION #2

Treasury staff comply with Policy requirements to maintain collateral at 100% of the repurchase agreement's face value, Mark-to-Market daily, or sufficiently in excess of the agreement's face value. (Priority 1)

#### RESPONSE

Staff recognizes that specific documentation of marking-to-market was not maintained and should have been. However, until a more formalized process could be developed, visual monitoring was used as an interim measure. On November 13, 1985, the Chief of Treasury set an internal policy of requiring 102% collateral for all repurchase agreements whose term extended beyond one day even though general market prices continued to rise. Specific prices were always available through the Telerate service to address issues of concern.

A system for formal documentation has already begun to be implemented in the following manner. On December 20, 1985, Wismer Associates conducted another training seminar on City premises to introduce Treasury and Accounting personnel to the Mark-to-Market report which is produced through the Moneymax system. A temporary employee hired specifically for data input and writing procedures was included in this training. The Mark-to-Market report is intended to be produced each morning. It tracks the value of collateral and compares it to user-defined margin requirements using market prices from the close of the previous day's business. At the end of December, some preliminary runs were produced.

While this report will produce the documentation necessary to produce physical evidence that monitoring occurs, there is one particular point worth high-lighting: it is only a snapshot of the collateral's value. As the Compliance Review suggests, the value at that moment of the market's closing will be different than the value at the market's opening the following day. Beyond that, intraday fluctuations continue to occur. The magnitude of those fluctuations triggers decisions to take further action. Relating these facts

Honorable Mayor and City Council RESPONSE TO AUDITOR'S OCTOBER 1985 COMPLIANCE REVIEW

to the Auditor's discussion, it would be difficult to assert that the "exposures" described (\$9,000 and \$102,000) existed at the time the repurchase agreement was executed, or terminated, for the Auditor's references are the closing prices listed in the <u>Wall Street Journal</u> (described in the report as "actual" value). Logically appraised, these calculations are at best general indications in the same sense the visual monitoring procedures were. Therefore, the most practical and effective procedure is to run the Mark-to-Market report daily and visually monitor the intraday fluctuations of selected securities. This is the essence of the system being implemented in the City of San Jose.

Internal procedures regarding repurchase agreement margin requirements will continue to be set by the Chief of Treasury depending on market conditions. GNMA's are no longer permitted as repurchase agreement collateral because that issuer, though backed by the full faith and credit of the U. S. government, is subject to more than the usual amount of price volatility. Pricing information is available from Telerate (there are several very useful screens dedicated to specific securities) and hard copy indications are reproduced in The Wall Street Journal, Barron's, The New York Times or other technical journals. Beginning in late January, it will be part of Treasury procedure to calculate manually the value of all repurchase agreement collateral at the time of the trade to document sufficiency of collateral. The calculations will be written on the rough draft of the confirmation for future inspection.

# RECOMMENDATION #3

Finance comply with Policy requirements to establish procedures to evaluate and monitor dealer financial condition and execute formal master repurchase agreements and services agreements with dealers. (Priority 1)

#### RESPONSE

This recommendation will be addressed in each of its three subsections:

1. "Finance establish procedures to evaluate and monitor dealer financial condition".

The Chief of Treasury intends to document these procedures by March 1, 1986. Financial statements were solicited from the City's dealers at the end of November, 1985. The statements requested were returned, filed, and currently await the analysis to be completed during February. It should be noted that the creditworthiness of the City's trading partners has already been substantially addressed through the requirements to deal solely with dealers reporting to the Market Report Division of the Federal Reserve or dealers meeting the credit ratings described in the Policy.

The lowest Keefe, Bruyette and Woods credit rating permitted by the Policy (C for major California banks) has the following characteristics: "Company is inherently a sound credit with no serious deficiencies, but financials reveal at least one fundamental area of weakness that prevents a higher rating. Company may recently have experienced a period of difficulty, but those pressures should not be long-term in nature. The company's ability to absorb a surprise, however, is less than that for organizations with better operating records."

Restricting the bulk of the City's trading partners to those who report to the Federal Reserve "offers some control and may reduce the likelihood of fraud." (Public Investor, Government Finance Officers Association, Volume 4, Number 4). The monitoring function of the New York Federal Reserve covers the following: (1) capital adequacy, (2) character in management, and (3) capacity in terms of trained personnel. In the wake of the failures of firms like E.S.M. Government Securities, Inc., and Bevill, Bresler & Schulman, Inc., traders and executives in the government securities industry said that the reporting dealers themselves were "...cutting off regional dealers and reviewing business relationships". (The Bond Buyer, April 24, 1985, pq. 1). The fraud perpetrated in financial statement preparation for E.S.M. also demonstrated that figures purporting to show capital adequacy are no guarantee of creditworthiness. Staff acknowledges that the additional analysis of the financial statements required by the Policy is a beneficial one, but the risk introduced by not having completed the exercise is negligible given the Investment Policy parameters already in place.

- 2. Finance "execute formal master repurchase agreements".
- 3. Finance "...execute service agreements with dealers".

The Chief of Treasury reviewed the Dealer Agreement drafted by the Attorney's Office in mid-summer and was concerned that it might not provide sufficient protection for certain transactions, e.g.; repurchase agreements. It was apparent that the two master agreements (Dealer Agreement and Master Repurchase Agreement) should logically be combined, for repurchase agreements are only one part of the scope of services a dealer would be expected to provide. For several months, sample master repurchase agreements were solicited from dealers and municipalities. At the same time it was expected that the Public Securities Association would release its draft prototype in the fall of 1985, and in mid-November that draft was finished. A copy was obtained in December 1985 and incorporated into the Dealer Agreement in its draft form. This was forwarded to the City Attorney for a comprehensive legal review (along with the safekeeping agreement described in Recommendation #1) on January 13, 1986. Assuming that our attorneys and the dealers have no major problems with the Agreements, we expect signed agreements to be on file by May 1, 1986.

Honorable Mayor and City Council RESPONSE TO AUDITOR'S OCTOBER 1985 COMPLIANCE REVIEW

# RECOMMENDATION #4

Treasury establish guidelines for repurchase agreements which:

- 1) allow substitution of securities only on an exception basis, and
- 2) limit the number of securities used as collateral. Treasury document reasons for exceptions to the guidelines. (Priority 1)

#### RESPONSE

- 1. Treasury has never permitted collateral substitutions without authorization. Care must be taken to define the core issue of this recommendation as one in which documentation was not available for one particular transaction. Staff will redouble its efforts to document the circumstances surrounding substitutions. Substitution in and of itself is not a risk factor if handled properly, and the actual number of occurrences is negligible compared to the volume of repurchase agreements handled during the year. Permitting substitution is a business accommodation for the dealers which optimizes the number of responsible trading partners willing to do business with the City.
- 2. The use of multiple securities as collateral does not "impede accurate monitoring of market value" as the Auditor maintains. It does become slightly more time consuming to research a larger number of price factors and assign corresponding market values. The accuracy of information is not affected in any way, nor is this a risk-inducing practice. Under the system described in response to Recommendation #2, this monitoring will be done automatically through Moneymax and it will be visually confirmed as well. Again, the core issue in this recommendation is related to paperwork. The reconciliation process does become more burdensome if more pieces of paper have to be pulled together for one repurchase agreement. It is in recognition of this internal operational difficulty that Treasury has restricted the number of pieces of collateral to five or less since the end of November.

# RECOMMENDATION #5

Finance obtain clarification from the Private Sector Investment, Committee regarding the issues of repurchase agreement collateral, issuer percentages, and financial institution qualifications. (Priority 2)

Honorable Mayor and City Council RESPONSE TO AUDITOR'S OCTOBER 1985 COMPLIANCE REVIEW

#### RESPONSE

# Clarification of Policy Intent

The Finance Department concurs with the desirability of meeting with the Private Sector Investment Panel to clear up any outstanding policy interpretation questions. We believe it would be desirable to schedule that meeting in March, prior to bringing the Policy back to City Council for its required anniversary review.

# Repurchase Agreement Collateral

Treasury takes issue with the Auditor's interpretation of the Policy in this instance. The repurchase agreement, in the Auditor's own reference, "represents a temporary purchase of the instrument" (emphasis added). This language is not loosely used; it describes a unique characteristic of the agreement. The direct exposure to the underlying security is very limited, particularly under the City's Investment Policy. In the unlikely event that one of the City's dealers went bankrupt, the securities (which have been maintained at a value equal to or greater than the value of the agreement) would be sold. They would not be held to maturity, for the primary virtue of a repurchase agreement is its liquidity and funds invested under the terms of an agreement would be required for cash flow purposes within days rather than years. Furthermore, it must be recognized that the City's investment parameters are conservative. If the Policy's maturity date restrictions were applied to repurchase agreement collateral, the universe of available U.S. Treasury and Agency securities issues would be substantially reduced (see Exhibit A). This would interfere further with the dealers' ability to be responsive to the City's need for this flexible investment vehicle.

#### Issuer Percentages

Treasury feels that the Auditor's treatment of this issue is intended to present a case for a broader allocation of business among a greater number of dealers. The City Council recently approved a Finance Department recommendation that the Investment Policy be amended to add more qualified names to the list of authorized firms. Further dealer diversification is going to occur naturally, and the results of that diversification process will continue to be available for inspection through the daily reports and the Broker Purchase Distribution Report which is included in the monthly report to Council.

It is not at all clear that any percentage limitation, much less 10%, should apply to the dealers with which the City executes repurchase agreements. In a repurchase agreement, the City's funds are not placed in the securities of the dealer. The dealer is not the issuer. The dealer is not the backer. The dealer has received cash and given up an equivalent or greater amount of government securities. If the dealer goes bankrupt, the custodial contract and the master repurchase agreement are intended to ensure complete recovery of those securities. These contractual arrangements are discussed in the response to Recommendation #3. Selected elements of the Investment Policy, such as this limitation, must be analyzed in the context of the whole document and not be narrowly construed.

If a percentage limitation is to be applied to the dealers with whom the City does business, it not at all clear that 10% should be the numerical parameter. Given the unique nature of the repurchase agreement, and the unpredictable nature of the dealers' abilities to compete for the City's business on any given day, a case could be made for a higher limit in a relatively large and stable portfolio.

#### RECOMMENDATION #6

Finance include in its Monthly Investment Report all investments which do not comply with Policy Provisions. Finance should indicate which investments are subject to on-going review for potential sale. (Priority 2)

#### RESPONSE

#### Purchases Prior to Policy

Treasury acknowledges that 6 SLMA issues in the City's portfolio were not listed in October due to an oversight. These issues will be listed in November's report.

#### RECOMMENDATION #7

Accounting ensure that safekeeping receipts are promptly received and reconciled. (Priority 1)

#### RESPONSE

Each security transaction results in several notices of confirmation, both upon its initiation and upon its maturation. A deposit notice, charge notice (purchase), a dealer confirmation of purchase price, a dealer confirmation of maturity proceeds, and a safekeeping advice accompany each purchase; and a credit advice (which includes a release of safekeeping) is sent upon maturity. These notices and confirmations are received for repos, as well as purchases of commercial paper, Treasury Bills, Treasury Notes, NCD's, Time Deposits, FFCB Discount Notes, etc. A single repo may have any number of securities associated with it, and while three to five are not uncommon, the number has been known to stretch to fifteen or more. In addition to purchases, advices are sent for each interest payment, and are matched to the related securities (often from prior month's activities) when the dollar amount of interest exceeds \$30,000. Sales are also associated with confirmation notices, but have not been frequent in recent months.

Honorable Mayor and City Council RESPONSE TO AUDITOR'S OCTOBER 1985 COMPLIANCE REVIEW

An analysis of security activity indicates that the volume of confirmation reconciliation is considerable. In September, the City portfolio showed 28 purchases (19 of which were repos), 36 maturities (19 of which were repos), 2 sales, and 15 interest payments (all over \$30,000); the Agency portfolio had 18 purchases (11 repos) and 23 maturities (11 repos). In October the volume was even heavier: the City portfolio had 38 purchases (20 repos), 40 maturities (21 repos), and 47 interest payments (3 over \$30,000); while the Agency showed 22 purchases (11 repos), 16 maturities (12 repos), and 4 interest payments (all under \$30,000). This volume equates to between 308 and 768 individual pieces of paper confirming transaction activity, most of which must be carefully matched to the internal confirmation documents and to each other.

Beginning in November, 1985, in response to the recommendation made in the September Compliance Report, a complete safekeeping transaction history was received from Wells Fargo Bank, in addition to the normal month-end statement of securities held in safekeeping. This was carefully reconciled, and the procedure has been added to the investment accounting function. Reconciliations between the Moneymax system and the General Ledger, and between Moneymax and the Monthly Investment Report are also part of the duties performed.

This heavy clerical volume was recognized when the Administration responses to the Arthur Young and Company Special Study were made in December, 1984. At that time, it was noted that implementation of the recommendations regarding document matching would necessitate the addition of an Accounting Technician position at the mid-year (1984-85) budget review. The position was not added because the Finance Department wanted to see if increased use of automation could free up the time required for this activity. The necessary additional time has not been freed up, so the position request is included in the Finance Department's 1985-86 mid-year budget request. As has been discussed elsewhere, the Redevelopment Agency has one part-time accountant who is responsible for all Agency general ledger, payroll, accounts payable/receivable and fixed asset accounting, as well as Agency investment accounting. Staff increases for Redevelopment Accounting have been approved.

In summary, Accounting is aware of their responsibilities in insuring prompt receipt and reconciliation of safekeeping confirmations, and has made and will continue to make every effort to accomplish this objective.

#### RECOMMENDATION #8

Treasury establish data entry standards to ensure the accuracy of MONEYMAX entry, including adequate issuer identification. (Priority 1)

Honorable Mayor and City Council RESPONSE TO AUDITOR'S OCTOBER 1985 COMPLIANCE REVIEW

#### RESPONSE

The Treasury Division's manual for Moneymax utilization, discussed in the response to Recommendation #2, will include the specifications for input regarding issuer identification. As mentioned in the same response, Treasury staff has received training and has begun to implement procedures for recording securities held as collateral for repurchase agreements. Again, as the training program continues, the utilization of Moneymax will approach its full potential.

As the Auditor noted, the first exception involving the Sears Savings Bank issuances occurred on September 17 and terminated October 1. The new daily portfolio report, with its accompanying calculations, was run for the first time on November 5 and could not have identified this exception.

#### RECOMMENDATION #9

Treasury enter the dealer's name and securities held as collateral for repurchase agreements into the MONEYMAX system. (Priority 1)

#### RESPONSE

The program to input all relevant information regarding repurchase agreements will begin in January as discussed in the response to Recommendation #2.

#### RECOMMENDATION #10

Treasury document daily investment strategy and purchase decisions. (Priority 2)

#### RESPONSE

As noted in the Auditor's report, documentation continues to be enhanced in order to provide a written overview of the day's investment activities. Improvements should be noted in a very short period of time. As discussed with the Finance Committee on January 6, 1986, approximately 4 forms are being completed on a daily basis with a checklist serving as a summary resource for reviewing the Investment Policy's parameters. These forms, along with the daily Moneymax reports, comprise the primary sources of information used to review investment transactions.

#### RECOMMENDATION #11

Treasury segregate the functions of investing funds and receiving investment income. (Priority 1)

Honorable Mayor and City Council RESPONSE TO AUDITOR'S OCTOBER 1985 COMPLIANCE REVIEW

#### RESPONSE

The Treasury organization is structured so that the primary features of the cash management program may be implemented and supervised within one unit. The prompt activation of cash is extremely important to an effective investment program. This structure provides an oversight and follow-through capability that would not be as efficient if the Cashiering Unit stood alone or was integrated into another section.

There is indeed a basic accounting control standard that prohibits one employee or department from handling all aspects of a transaction from beginning to end. "If management is to direct the activities of (an organization) according to plan, every transaction should involve four steps; it should be authorized, approved, executed and recorded. Accounting control will be enhanced if each of these steps is performed by relatively independent employees or departments. No single department will then be in a position to complete a transaction which has not been reviewed, approved, and recorded by other departments." (Principles of Auditing, Meigs, Larsen & Meigs, pg. 143).

Finance feels its supervisors provide part of the requisite review and also prove the accuracy of the work performed by its employees. Accounting completes the review of the transactions through the reconciliation process and performs the record keeping function. In this particular situation, the execution of investment transactions is not performed by the same individual(s) who are responsible for banking the cash on a daily basis. It is not possible to initiate and complete unauthorized transactions because of the amount of supporting documentation required and the number of people who are involved in each transaction.

In response to the concerns leading to this recommendation Treasury has implemented a procedure whereby the Chief of Treasury approves all investment-related revenue vouchers. If it is determined in subsequent reviews that this is not an adequate response, Treasury will be willing to explore this issue further.

#### RECOMMENDATION #12

Finance establish additional procedures to ensure that controls are functioning and written verification of purchases and sales is complete and timely. Specifically, procedures need to be established to: 1) monitor compliance with Policy provisions regarding release of funds or securities; 2) provide for 24-hour preparation and mailing of confirmations; 3) implement pre-numbered and controlled confirmation documents and; 4) date stamp and reconcile dealer, safekeeping, debit and credit advices as received. (Priority 2)

#### RESPONSE

- 1. The documentation which is required to verify compliance with the Policy with regard to the release of funds or securities does consist of the appropriate initials on the Transaction Control Log. The deficiency noted consisted of two occasions upon which initials were not evident. Treasury will not prescribe additional procedures in this case but will emphasize the importance of maintaining the log so that documentation always exists.
- 2. The typed confirmations, as verified in the Auditor's follow-up to Recommendation #2, Prior Findings, are submitted to the Chief of Treasury within 24 hours, not two days after settlement. The signature process has been expedited, but it is highly unlikely that all written confirmations could ever be physically processed and in the mail within 24 hours.

Finance will propose an amendment to this section of the Investment Policy which will change the 24 hour requirement to 3 working days.

Treasury will modify the Transaction Control Log to include a reference to bank call-backs received when preformatted wire transfers were not on file for certain transactions.

- 3. As noted in the Auditor's report, prenumbered confirmation forms will be used by Treasury staff in the near future. It is planned to utilize the Moneymax application which produces confirmations automatically, thereby eliminating the corresponding drafting and typing effort. This feature will be incorporated into training sessions planned for March and April of 1986. Prior to these sessions, Treasury staff members will be scheduled to attend classes which offer IBM PC training and provide some exposure to Lotus 1-2-3. Greater utilization of the Moneymax system will then be possible and new applications will be implemented more smoothly upon the completion of these fundamental prerequisites.
- 4. Accounting staff has been directed to follow up on non-receipt of confirmation advices after one week. Date stamping of all debit and credit advices has also been instituted. As discussed in the response to Recommendation #7, time delays in reconciliation are clearly not desirable and all such reconciliations are currently up-to-date.

Respectfully submitted,

Edward G. Schilling Director of Finance

EGS:hh 5646F/0272F/0220F

## SUMMARY OF COMPLIANCE QUESTIONS FOR REVIEW OF SEPTEMBER 1985 AND OCTOBER 1985 INVESTMENT TRANSACTIONS CITY AND REDEVELOPMENT

Based on Review of Finance Documentation Did all Transactions Meet Criteria? September October 1985 Compliance Question 1985 A. PREQUALIFICATION OF DEALERS 1. Is the Dealer on the list of Govern-YES(1) NO ment Security Dealers Reporting to Market Report Division of Federal Reserve? 2. Has the Dealer or Bank filed an YES YES acknowledgement of receipt and review of the City's Investment Policy with Treasury? 3. Have Financial Statements been NO NO filed with Treasury? Do the Financial Statements include NO NO a Balance Sheet and a Profit and Loss Statement? Are the Financial Statements NO NO current? Has Treasury reviewed the NO NO Financial Statements? Has a Services Agreement been NO NO executed?

<sup>(1)</sup> In September, banks and savings and loans acting as dealers were not included for this question.

## SUMMARY OF COMPLIANCE QUESTIONS FOR REVIEW OF SEPTEMBER 1985 AND OCTOBER 1985 INVESTMENT TRANSACTIONS CITY AND REDEVELOPMENT

			Based on Review of Finance Documentation Did all Transactions Meet Criteria?		
	Comp	oliance Question	September 1985	October 1985	
В.	PROV	SIONS APPLYING TO ALL PURCHASES			
	1.	Purchase is of an approved instrument?	YES	NO	
	2.	Purchase Maturity does not exceed policy limits for instrument?	YES	YES	
	3.	Wire Transfer of funds initiated by employee other than employee initiating investment?	NOT REVIEWED	NO	
	4.	Wire Transfer of funds carried out according to the terms of preformatted Wire Transfer letter?	NOT REVIEWED	NO	
C.	PORTFOLIO MIX				
	1.	Policy limits for category of instruments not exceeded?	YES	YES	
	2.	Total with a single issuer, other than government issues:			
		<ul> <li>a) Does not exceed 10% of total portfolio;</li> </ul>	NOT REVIEWED	МО	
		b) For uninsured-uncollateralized issues, does not exceed 5% of of total portfolio?	NOT REVIEWED	YES	
D.	TIME DEPOSITS - BANKS AND SAVINGS AND LOANS				
	1.	Bank or savings and loan is located in San Jose area (Santa Clara County)?	YES	YES	
	2.	If not San Jose area, is it a minority bank?	NONE	NONE	

## SUMMARY OF COMPLIANCE QUESTIONS FOR REVIEW OF SEPTEMBER 1985 AND OCTOBER 1985 INVESTMENT TRANSACTIONS CITY AND REDEVELOPMENT

Based on Review of Finance Documentation Did all Transactions Meet Criteria? September October Compliance Question 1985 1985 3. Is a Contract for Public Funds Deposit YES YES on file? Is a Waiver for Collateralization on YES YES file (for insured portion)? For uninsured portion (over \$100,000), is the deposit with a bank or savings and loan with a Keefe, Bruyette and Woods rating of "B" or better, unless a "selected California bank" (Bank of of America or Wells Fargo) rated "C" or better? YES NONE E. U. S. GOVERNMENT AGENCY ISSUES Is issue by one of the following: 1. o Federal Farm Credit Bank o Federal Home Loan Bank; or o Federal National Mortgage NOT Association? REVIEWED NO 2. REPURCHASE AGREEMENTS Collateral is U.S. Treasury or NOT NO Government Agency issue approved REVIEWED for purchase by Policy? 2. If overnight, collateral is equal NOT YES to 100% of the repurchase agreement's REVIEWED face value? 3. If other than overnight, collateral is marked to market on a daily basis and maintained equal to 100% of the repurchase agreement's face value; or is sufficiently in excess of the NOT repurchase agreements face value? REVIEWED NO

## SUMMARY OF COMPLIANCE QUESTIONS FOR REVIEW OF SEPTEMBER 1985 AND OCTOBER 1985 INVESTMENT TRANSACTIONS CITY AND REDEVELOPMENT

Based on Review of Finance Documentation Did all Transactions Meet Criteria? September October Compliance Question 1985 1985 G. REVERSE REPURCHASE NONE NONE H. BANKER'S ACCEPTANCES AND NEGOTIABLE CERTIFICATES OF DEPOSIT Is the issuer a bank or savings and loan with a Keefe, Bruyette and Woods rating of "B" or better, unless a "selected California bank" (Bank of America or Wells Fargo) rated "C" or better? YES NONE I. COMMERCIAL PAPER 1. Is this a domestic corporation? YES YES 2. Does this institution have the highest rating by Moody's or Standard and Poor's? YES YES 3. Does this institution have total YES YES assets of \$500,000,000 or more? Does this institution have an "A" rating or higher on its own indebtedness other than its commercial paper? YES YES J. SAFEKEEPING-TREASURY PROCEDURES Person initiating release of 1. NOT NONE securities is not same person REVIEWED initiating sale? 2. Written confirmation for release of City-owned securities was transmitted to Safekeeper within NOT 24 hours of telephone instructions. REVIEWED NONE

### SUMMARY OF COMPLIANCE QUESTIONS FOR REVIEW OF SEPTEMBER 1985 AND OCTOBER 1985 INVESTMENT TRANSACTIONS CITY AND REDEVELOPMENT

Based on Review of Finance Documentation Did all Transactions Meet Criteria? September October Compliance Question 1985 1985 K. SAFEKEEPING - SECURITY/COLLATERAL HELD 1. Collateral held by a Safekeeping NOT NO Agent under the terms of a Safe-REVIEWED keeping Agreement with the City? 2. For securities serving as collateral for a repurchase agreement which are not held by a safekeeping agent, are the securities held by a third party custodian with a Safekeeping Agree-NOT ment with the City? REVIEWED NONE 3. For uninsured/collateralized Time Deposits in a savings and loan, is collateral held by the Federal Home NOT Loan Bank? REVIEWED NONE For uninsured/collaterized Time Deposits in a bank, is collateral held in the City's name in: a) The issuing banks' trust department, provided the bank has a Safekeeping NOT Agreement with the City, or REVIEWED NONE b) In the San Francisco Federal NOT Reserve Bank? REVIEWED NONE

# SUMMARY OF COMPLIANCE QUESTIONS FOR REVIEW OF SEPTEMBER 1985 AND OCTOBER 1985 INVESTMENT TRANSACTIONS CITY AND REDEVELOPMENT

Based on Review of
Finance Documentation
Did all Transactions
Meet Criteria?

		neet of fter fa:	
		September	October 1985
OTHER AR	EAS		
1.	Was sale necessary to meet cash needs?	NO	NONE
2.	Is documentation adequate to substantiate compliance?	NO	NO
3.	Are control procedures functioning?	NO	NO

### APPENDIX B Safekeeping Receipt - Bank of America

#### CONFIRMATION OF TRANSACTION

- 1. The confirmation of this transaction in no way changes or cancels any other agreements or account arrangments existing between us even though this transaction may be subject to them and may involve the same securities.
- 2. Securities may be commingled (itemized) with securities of other customers. Unless we both agree in writing, the <u>identical</u> securities bought, held or carried for your account will not have to be delivered to you, although actual receipt of securities is intended by both of us. All such securities shall be fungible (replaceable, one by another).
- 3. If this transaction is a sale, actual delivery of the securities was agreed. If they are not already in our possession, we have acted upon your representation that you or your principal own such securities and will promptly -not later than settlement date- deposit them in proper form with us. this transaction is a purchase, prompt payment was agreed. If you or your principal have not already placed funds with us for this purpose we have acted upon your representation that you will deliver sufficient funds to us not later than the settlement date to pay the amount due in full. If payment is not made by the settlement date, we will charge you interest from that date to the day we receive your payment. We may, if we wish, without notice to you cancel, complete, or liquidate any transaction if you don't deliver the securities or pay us by the settlement date. You will be liable to us for any resulting loss, including -without limitation- all expenses and other costs incurred by us, with interest.
- 4. Unless we have otherwise agreed, these securities, which are not held as collateral on any debts or commitments, will be delivered to you upon receipt from transfer agents and, if registrable, will be registered in the name of the account.
- 5. This agreement shall inure to any successors of Bank of America NT&SA, regardless of changes in personnel unless we have otherwise agreed.
- 6. "MISC" includes foreign currency conversion, commissions paid other brokers etc.
- 7. You agreed to pay any service charge made by us as a cost of this transaction, based on our current schedule, which will be made available to you upon request.

(Appendix B)

#### APPENDIX C Safekeeping Receipt - Wells Fargo

Following is the language contained in the reverse side of the Wells Fargo Safekeeping receipt:

This transaction is subject in all particulars to the rules of any exchange or market on which it was executed. The name of the broker or dealer in the transaction and time of execution will be furnished on request. If this statement is not correct please advise at once. We reserve the right to correct this statement in case of error.

If this transaction involves <u>Municipal</u> <u>Securities</u>, call features may exist which could affect yield. Complete call information will be provided upon written request.

#### PLEASE NOTE:

If this transaction involves a <u>Wells Fargo & Co. Commercial Paper Note</u>, such note is a liability of Wells Fargo & Co. solely and is in no way an obligation of Wells Fargo Bank, N.A. Furthermore such note is not insured by the FDIC.

### THIS STATEMENT SHOULD BE RETAINED FOR INCOME TAX PURPOSES SAFEKEEPING TERMS AND CONDITIONS

You authorize and request the Bank to hold and dispose of any security now or hereafter received by it from you in safekeeping in accordance herewith and to perform the following services as a depositary for hire with the law of bailment applying with respect to such security.

- (1) To surrender for payment coupons, a matured security, or a security called for redemption, and when requested in writing by you, to forward the security for exchange or conversion except that the Bank shall not be obligated to inform you of the maturity or calling for payment of any security nor be responsible for the failure to present any security for payment.
- (2) To properly account for all income received as well as for any principal payments received upon maturity, redemption, or sale thereof.
- (3) To furnish you or your auditors upon your written request with a list of securities then held by the Bank in safekeeping.
- (4) To permit inspection at all reasonable times by you or your auditors upon your written request of the securities held

in safekeeping and the Bank's records relating to these securities.

- (5) The Bank shall have no responsibility or liability for any loss or damage due to any act, civil commotion, fire or other casualty, and other causes beyond the reasonable control of the Bank.
- (6) The Bank may hold any or all of your securities in bearer form or, if not available in bearer form, registered in your name or in book-entry form in the Bank's name.
- (7) The Bank shall receive as compensation for its safekeeping services hereunder a fee as determined by the Bank's current schedule of fees and charges, and shall be reimbursed for any incidental expenses incurred on your behalf in connection with such services. If indicated on this receipt, the Bank shall be entitled to charge its fees and charges directly to your indicated account.
- (8) Should any adverse or conflicting claims with respect to any security held by the Bank in safekeeping hereunder be made or should the Bank be served with or have notice of any legal process whatsoever affecting or which in the judgement of the Bank purports to affect any or all such securities, the Bank may refuse to deliver such securities in either or any of said events you agree that the Bank shall incur no liability to you and you agree to hold harmless and indemnify the Bank against all liability, loss cost, damage, counsel fees and expenses suffered or incurred by the Bank in or about advising, defending, or protecting its interest or rights.
- (9) If the ownership of any security is by joint tenancy, any owner may, upon identification satisfactory to the Bank, order the sale of the security, direct the delivery of the proceeds of such a sale or withdraw the security from safekeeping.
- (10) In the event of your death or the death of any other owner of the securities, the Bank may hold such securities until all then applicable laws have been complied with.
- (11) Either you or the Bank may terminate this safekeeping agreement at any time upon written notice. If the bank terminates this safekeeping agreement, the termination will not be effective until the Bank delivers any securities held hereunder to you or pursuant to your instruction. If no instruction is received from you within five (5) days of notice

(Appendix C - Page 2)



### CITY OF SAN JOSÉ, CALIFORNIA

151 W. MISSION STREET, ROOM 109 SAN JOSE, CALIFORNIA 95110 (408) 277-4601

OFFICE OF THE CITY AUDITOR

December 1, 1985 5-42C-12

Edward G. Schilling Director of Finance 801 North First Street, Room 227 San Jose, CA 95110

Dear Ed:

In conducting the monthly review of investment transactions, audit staff has identified a numerical exception which occurred in the City portfolio in September 1985. This exception and underlying cause will be reported in our next monthly report. However, we are now notifying you of this discovery in order that you can take steps to comply with the Investment Policy's reporting requirements.

The numerical exception occurred on September 17, 1985 when a purchase of \$6,080,025.33 Sears Savings Bank Discounted Commercial Paper, combined with \$14,000,000 Sears Savings Bank NCD's already in the portfolio, caused the insurer total to exceed 5% of the portfolio total. The exception continued until October 1, 1985 when the commercial paper matured.

Sincerely,

Gerald A. Silva City Auditor

A Silva

GS:a

cc: Deborah Kelly